Global High Yield

Diversification in the asset class

June 2016

Authored by:

Mary Bowers, CFA, Portfolio Manager, Global High Yield

Julian Moore, Product Specialist, Global Credit

HSBC Global Asset Management

Global High Yield
Executive Summary

Introduction

High yield (HY) has been in the headlines for months now as a troubled asset class. This negative press echoes with a sentiment that harks back to its humble origins as the “junk bonds” of the late 70s and early 80s. Looking beyond the recent volatility however, it is clear that the evolution of the HY asset class has garnered it unquestionable legitimacy and a justified role alongside other established asset classes in investor portfolios.

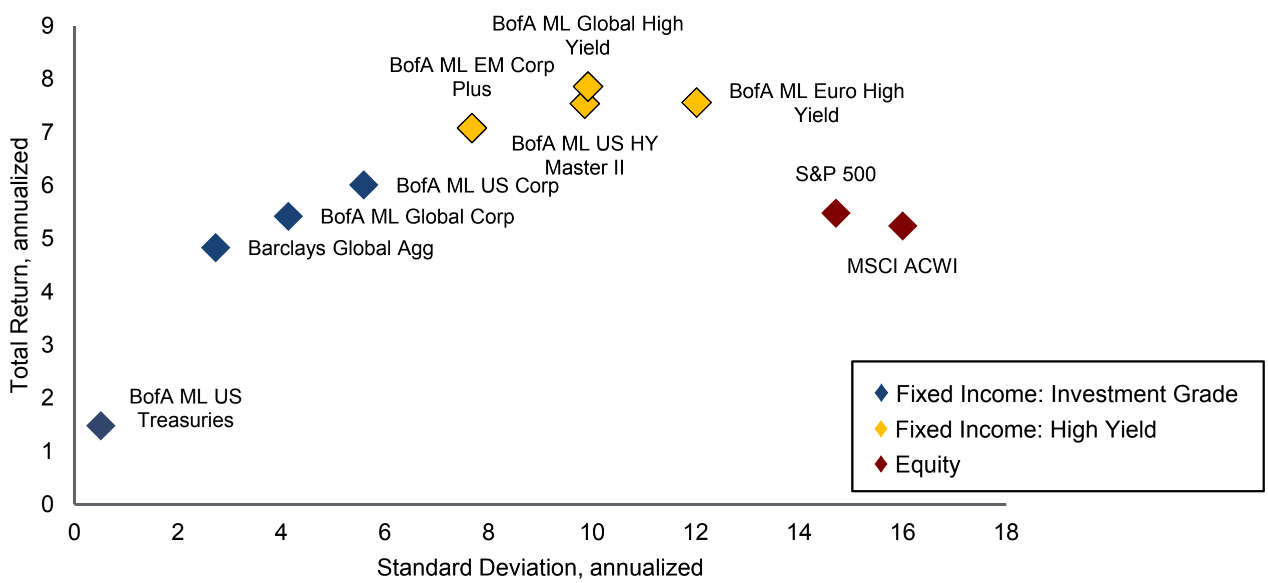
High yield bonds offer investors an attractive risk-return profile – more similar to that of equities than to more traditional fixed income sectors such as government or investment grade bonds. (See Figure 1.) HY can provide equity-like returns with the capital structure and regular dividend benefits of a fixed income security.

A more interesting and important point about the high yield asset class has been its global expansion. European and emerging high yield markets have grown and developed over the past 15 years to a point where a global allocation to high yield is now more attractive from a risk-adjusted return perspective than a purely US allocation. In our view, global high yield should be a staple allocation in investor portfolios.

Global High Yield
Asset Class Viewpoint

Today many investors recognize the benefits of high yield as an asset class but this has not always been the case. Prior to the 1970s high yield bonds were typically from fallen angels, companies that had been investment grade at issuance and subsequently downgraded to “junk” status. The challenging economic landscape of the 1970s, however, paved the way for today’s high yield market: as companies with lower credit ratings were unable to secure bank financing, they were forced to access the capital markets and issue high yielding bonds to attract investors. Today, high yield bonds represent a large, well-diversified and mature fixed income market that can offer investors attractive risk-adjusted returns.

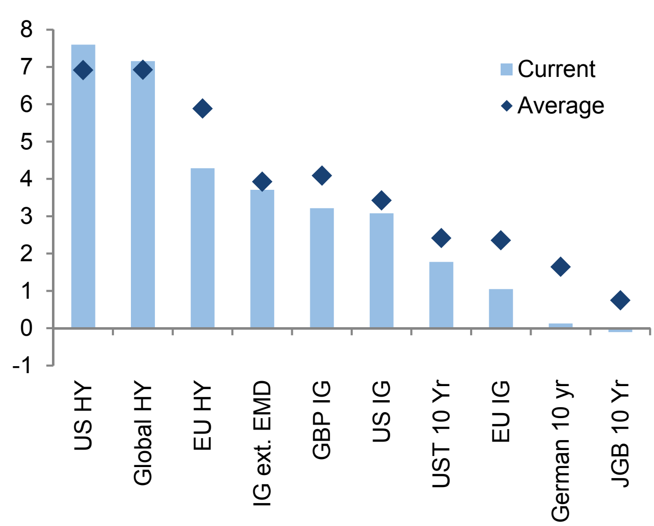
Figure 1. Asset Class Risk/Return Comparison (Over 15 Years)



Source: Morningstar Direct. Data based on 15 year annualized returns as of April 30, 2016. See Appendix for index descriptions.

High yield bonds have typically “out yielded” most other fixed income asset classes. In today’s post-financial crisis, low yield economy, investors have focused on the yield advantage that HY bonds can provide. If we look at current yields and post financial crisis average yields of various fixed income sectors, we see that high yield not only out yields other asset classes but has a current yield that is in line with or above its post financial crisis average. Other fixed income segments are still under yielding their average levels. Thus for investors in the pursuit of yield, high yield provides a compelling proposition in the current economic environment. (See Figure 2.)

Figure 2. Post Financial Crisis Avg. Fixed Income Yields



Source: BofA Merrill Lynch as of May 18, 2016.
Averages from December 31, 2009 through April 30, 2016.
See Appendix for fixed income index representation.

Global High Yield
Growth of the Market

The more interesting phenomenon in the high yield market, is the growth, depth, diversity and relative attractiveness of the global high yield space. The evolution of the global high yield market in size and diversity of issuer and industry has led to an overall trend of decreasing correlations between regional US, European and Emerging market components. As a result, global high yield can provide investors with better risk-adjusted returns than a pure US high yield allocation.

Global High Yield Market Growth

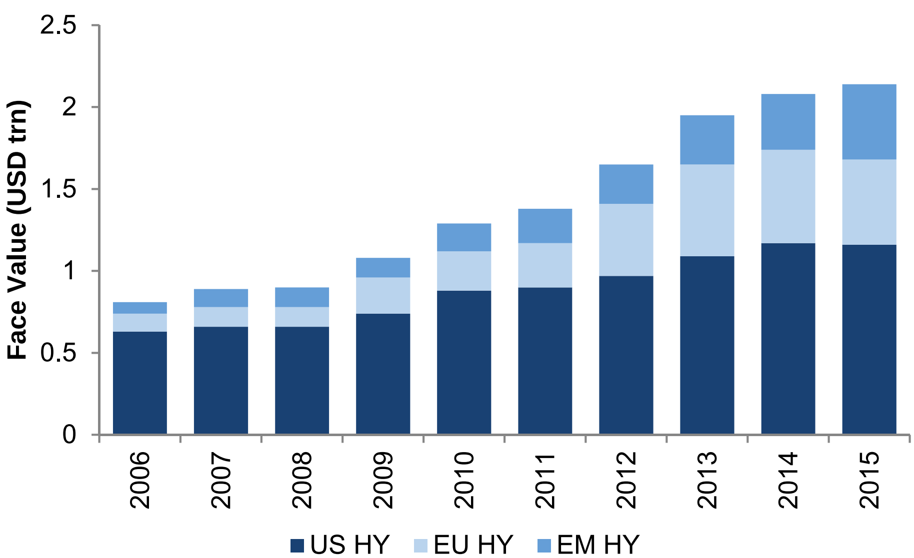
In 2005, the global high yield space was dominated by the US market which was 82% US, 10% Europe and 9% emerging markets (EM) bonds. In the last 10 years, however, the global high yield market has nearly tripled in size from $765 billion to $2.14 trillion. Today, the US represents just 56% of the market value of the global index. Europe and EM have seen significant growth representing 24% and 21% of the index, respectively. (See Figure 3.)

Growth of the Global High Yield Market

	2005	2015
US HY	82%	56%
EU HY	10%	24%
EM HY	9%	21%

Source: BofA Merrill Lynch as of December 31, 2015.
See Appendix for asset class index representation.

Figure 3. Growth of the Global High Yield Market



Source: BofA Merrill Lynch as of December 31, 2015.
See Appendix for asset class index representation.

With the extensive face value growth in European and EM high yield, we have also seen a steady increase in constituents. Over the same ten-year period (2006-2015) the number of high yield constituents in Europe has increased by 256% from 147 to 523 issuers and in EM by 220% from 193 to 617 issuers. This brings the overall number of constituents in global high yield to 3012 versus US high yield with 1780 issuers.

Global High Yield
Global Diversification

Market Structure and Diversification

Regional diversification is one of the factors that makes a global high yield allocation beneficial from a risk-adjusted return perspective. Compared to US high yield, which from a global perspective has been the most mature and developed market historically, the last 15 years has seen regional markets experience increasing diversification across industries and issuers.

Sector Diversification

The European high yield space has evolved from being heavily weighted in Technology, Media & Telecom (TMT) in 2000, when the sector represented 52% of the market value, versus 18% today. This progression has been largely due to a broad trend in Europe since the 2008 financial crisis, where corporations have had to turn to the public markets for funding. Increased bank regulation since the crisis has led banks to reduce their loan exposures which had previously served as the primary source of funding for corporate Europe.

Emerging markets have experienced a similar trend of issuer and industry diversification – although recently EM high yield has seen a spike in its exposure to energy from 11% to 28%. This increase in energy has been mainly attributable to the 2015 downgrades of Russian and Brazilian energy companies to high yield status. However, due to the quasi-sovereign nature of some of these EM energy companies, the market views them differently due to the implied government support they enjoy. Therefore, while energy is a now a larger part of EM high yield, it exhibits distinctly different characteristics than the energy industry in the US, diversifying the overall energy exposure of the global index.

Ratings and Duration Diversification

European and EM high yield markets also differ from the US in credit quality and duration. From a credit quality perspective, both Europe and EM high yield exhibit a higher credit quality than the US. This has been the case historically with European corporations generally having a higher quality bias than their US counterparts and is exhibited by an average index rating of BB-, one notch higher than the US at B+. The same holds true for EM high yield where the average index rating is again one notch higher at BB- given the market structure and investor appetite in EM.

With regards to duration, we can see a similar divergence between the markets. Both European and EM markets have a shorter duration than US high yield. Currently, US high yield has a duration of 4.21 years with Europe and EM at 3.39 and 3.75 years, respectively. These duration characteristics have been basically static over the last 10 years across US, EM and European high yield markets

High Yield Market Statistics

	Average Rating	Duration (yrs)
US HY	B+	4.21
EU HY	BB-	3.39
EM HY	BB-	3.78

Source: BofA Merrill Lynch as of April 30, 2016.
See Appendix for asset class index representation.

Diversity in Performance

These divergent regional trends in sector composition, quality and duration are especially important for investors because of their impact on returns, and more specifically, for the higher risk-adjusted returns achievable with a global high yield allocation versus a US allocation.

Performance variation across the US, European and EM regions has been significant. (See Figure 4.) In fact the average difference in yearly total returns between the top performing and the bottom performing region is 8.0% over the past 10 years. The reason for this lies in the different characteristics and make-up of the regional indices.

Figure 4. High Yield Market Total Returns (USD)

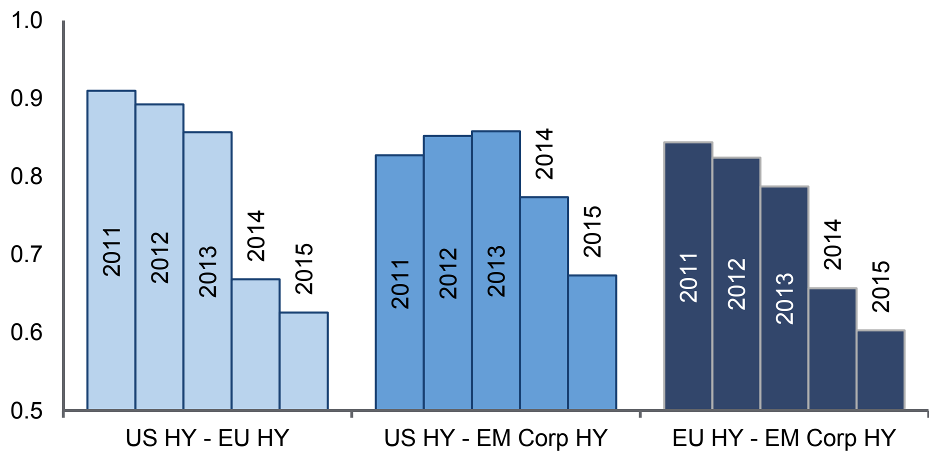
	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	(2006 – 2015)*
Best Performing Region in each year	EU HY 13.8	EM HY 3.5	US HY -26.4	EU HY 74.9	EM HY 17.9	US HY 4.4	EU HY 28.1	EU HY 10.4	EU HY 5.6	EM HY 2.9	**EU HY 8.4**
	Global HY 12.0	US HY 2.2	Global HY -27.0	EM HY 65.3	EU HY 15.4	Global HY 3.2	EM HY 23.6	US HY 7.4	Global HY 2.5	EU HY 1.1	**Global HY 7.4**
	US HY 11.8	Global HY 1.7	EM HY -30.6	Global HY 60.7	Global HY 15.4	EM HY 0.1	Global HY 18.9	Global HY 7.1	US HY 2.5	Global HY -2.0	**EM HY 6.8**
Worst Performing Region in each year	EM HY 9.4	EU HY -0.9	EU HY -33.1	US HY 57.5	US HY 15.2	EU HY -2.3	US HY 15.6	EM HY 0.6	EM HY -2.0	US HY -4.6	**US HY 6.8**
Difference between highest and lowest regional return	4.4	4.4	6.7	17.4	2.7	6.7	12.5	9.8	7.6	7.6	1.6

** 10 Year annualized period.*
Source: Bloomberg, BofA Merrill Lynch December 31, 2015.
See Appendix for asset class index representation.

One example of how divergent regional trends have impacted returns can be seen in the different sector compositions of each region. The Energy sector for example, comprised upwards of 15% of the US high yield index in 2015 and caused the US market to finish the year with a return of -4.6%. Europe had just 5% exposure to energy and posted a positive 1.1% return in 2015. Furthermore, despite overall negative headlines around increased energy exposure in emerging markets, limited new issuance and quasi-sovereign support for fallen angel energy companies enabled EM high yield to produce a positive 2.9% return in 2015.

A result of the evolution and maturation of European and EM high yield has been a decrease in correlations between these markets. (See Figure 5.) Diverging credit and macro-economic trends in the post-financial crisis environment has also been an important factor in declining correlations.

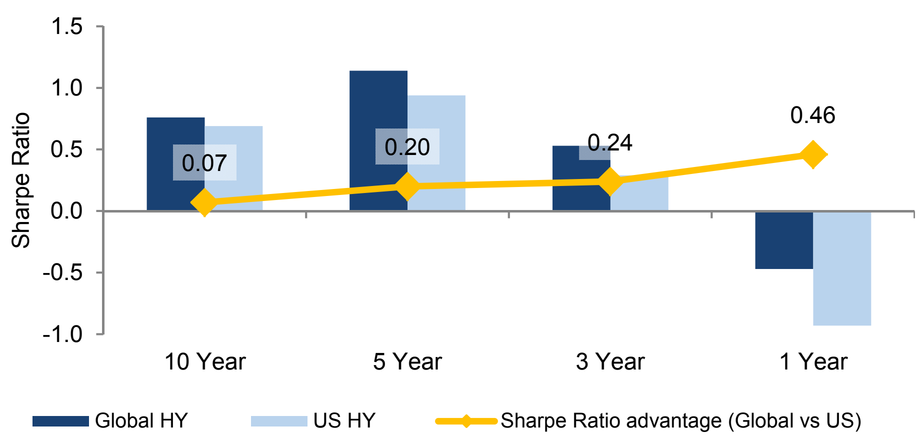
Figure 5. High Yield Market Regional Correlations



Rolling 3 year correlations using weekly observations.
Source: Bloomberg BofA Merrill Lynch, HSBC Global Asset Management as of December 31, 2015.
See Appendix for asset class index representation.

Declining correlations have helped the global high yield market to deliver higher risk-adjusted returns, or higher Sharpe ratios than the US market alone. As correlations have decreased over time we can see that global HY's Sharpe ratio has increased relative to that of US HY. (See Figure 6.) We expect correlations to continue to decrease modestly and Sharpe ratios to improve as European and EM high yield markets continue to grow and mature.

Figure 6. Global HY vs US HY Sharpe Ratios



Source: Bloomberg BofA Merrill Lynch, HSBC Global Asset Management as of December 31, 2015.
See Appendix for asset class index representation.

Conclusion

The evolution of the global high yield asset class over the last 10 years has made it a compelling alternative to a purely US HY allocation. The growth and maturity of its constituent markets has resulted in a highly diversified market with an attractive risk-adjusted return potential. A global high yield strategy does come with additional layers of complexity and requires robust opportunity and risk analysis to capitalize on market inefficiencies. Investors looking for a global allocation must find managers capable of taking advantage of the opportunities and benefits of the global high yield market.

Why is HSBC well positioned to take advantage of these opportunities?

As a global credit manager HSBC Global Asset Management has put in place a credit platform uniquely structured to take advantage of the global opportunity set that High Yield presents. Through the use of a sleeve structure where management and research is delegated to specialist regional teams our global portfolios are able to take advantage of local market expertise on a global level.

At the heart of our investment process is our global team of credit research analysts who thanks to HSBC's global footprint are located around the world in close proximity to the issuers they cover. They in turn support the local investment teams that use their local market expertise to manage their respective sleeve of the global portfolio. Each strategy also has a lead investment manager responsible for the aggregate portfolio, managing the allocation between the sleeves as well as the overall credit and duration positioning of the strategy.

This structure allows our global credit portfolios to efficiently marry the bottom up local management and research from each sleeve with the top down allocation and positioning from the lead manager. The result is a strategy that can deliver local market expertise with global perspective and accountability.

Authors

Mary Bowers, CFA
Portfolio Manager, Global High Yield
HSBC Global Asset Management

Julian Moore
Global Credit Product Specialist
HSBC Global Asset Management

Mary Bowers is a Senior Portfolio Manager for Global High Yield portfolios. She joined HSBC Global Asset Management in September 2013. Prior to joining HSBC, Ms. Bowers worked for Aberdeen Asset Management as part of the Artio Global (formerly Julius Baer Asset Management) high yield team which was acquired in the spring of 2013. She acted as a portfolio manager for the global high yield products at Aberdeen/Artio for 10 years. From 2001 to 2003 she was an analyst at Deutsche Bank in the global energy and power investment banking group. She has been working in the industry since 2001. Ms. Bowers has a BA in history from Yale University. She is a CFA Charterholder.

Julian Moore joined HSBC Global Asset Management in 2005 as a product specialist for HSBC's quantitative product offering in the Americas and has been working in the industry since 1997. Prior to joining HSBC Global Asset Management, he was a project manager in the international business development team with Sinopia Asset Management (HSBC's quantitative specialist) in Paris. Prior to working for Sinopia Asset Management, he worked for Merrill Lynch in London, Luxembourg and New York. Mr. Moore earned his B.A. from the University of Buckingham, England in 1996 and his MBA from Copenhagen Business School, Denmark in 2011.

Important information

For institutional investor and financial advisor use only. Not for further distribution.

This document is for information only and does not constitute investment advice, a solicitation or a recommendation to buy, sell or subscribe to any investment. It is not intended to provide and should not be relied upon for accounting, legal or tax advice.

HSBC Global Asset Management is the marketing name for the asset management businesses of HSBC Holdings Plc. HSBC Global Asset Management (USA) Inc. is an investment adviser registered with the US Securities and Exchange Commission.

HSBC Global Asset Management has based this material on information obtained from sources it believes to be reliable but which it has not independently verified. HSBC Global Asset Management and HSBC Group accept no responsibility as to its accuracy or completeness.

The views expressed were held at the time of preparation and are subject to change without notice.

Forecasts, projections or targets are indicative only and are not guaranteed in any way. HSBC Global Asset Management accepts no liability for any failure to meet such forecasts, projections or targets.

Past performance is no guarantee of future results.

Risk considerations. There is no assurance that a portfolio will achieve its investment objective or will work under all market conditions. The value of investments may go down as well as up and you may not get back the amount originally invested. Portfolios may be subject to certain additional risks, which should be considered carefully along with their investment objectives and fees. **Fixed income** is subject to credit and interest rate risk. Credit risk refers to the ability of an issuer to make timely payments of interest and principal. Interest rate risk refers to fluctuations in the value of a fixed income security that result from changes in the general level of interest rates. In a declining interest rate environment, a portfolio may generate less income. In a rising interest-rate environment, bond prices fall. **High Yield**. Investments in high yield securities (commonly referred to as “junk bonds”) are often considered speculative investments and have significantly higher credit risk than investment grade securities. The prices of high yield securities, which may be less liquid than higher rated securities, may be more volatile and more vulnerable to adverse market, economic or political conditions. **Foreign and emerging markets**. Investments in foreign markets involve risks such as currency rate fluctuations, potential differences in accounting and taxation policies, as well as possible political, economic, and market risks. These risks are heightened for investments in emerging markets which are also subject to greater illiquidity and volatility than developed foreign markets.

Index returns assume reinvestment of all distributions and not reflect fees or expenses. You cannot invest directly in an index.

Barclays POINT/Global Family of Indices ©2016 Barclays Inc. Used with permission.

Source: BofA Merrill Lynch, used with permission. BOFA MERRILL LYNCH IS LICENSING THE BOFA MERRILL LYNCH INDICES "AS IS," MAKES NO WARRANTIES REGARDING SAME, DOES NOT GUARANTEE THE SUITABILITY, QUALITY, ACCURACY, TIMELINESS, AND/OR COMPLETENESS OF THE BOFA MERRILL LYNCH INDICES OR ANY DATA INCLUDED IN, RELATED TO, OR DERIVED THEREFROM, ASSUMES NO LIABILITY IN CONNECTION WITH THEIR USE, AND DOES NOT SPONSOR, ENDORSE, OR RECOMMEND HSBC GLOBAL ASSET MANAGEMENT, OR ANY OF ITS PRODUCTS OR SERVICES.

All MSCI data is provided "as is." The strategy described here is not sponsored or endorsed by MSCI. Neither MSCI, its affiliates nor any MSCI data provider has any liability in connection with the MSCI data or strategy described here. Copying or redistributing the MSCI data is strictly prohibited.

The S&P 500® (“Index”) is a product of S&P Dow Jones Indices LLC (“SPDJI”), and has been licensed for use by HSBC Global Asset Management. Standard & Poor's® and S&P® are registered trademarks of Standard & Poor's Financial Services LLC ("S&P"); Dow Jones® is a registered trademark of Dow Jones Trademark Holdings LLC ("Dow Jones").HSBC Global Asset Management’s investment products are not sponsored, endorsed, sold or promoted by SPDJI, Dow Jones, S&P, their respective affiliates and none of these parties make any representation regarding the advisability of investing in such products, nor do they have liability for any errors, omissions, or interruptions of the S&P 500® Index.

US persons (both entities and individuals) are subject to US taxation on their worldwide income and may be subject to tax and other filing obligations with respect to their US and non-US accounts. The Foreign Account Tax Compliance Act (FATCA) is a US law designed to prevent the use of non-US accounts or non-US entities to avoid US taxation of income and assets. To meet this objective, FATCA imposes on US and non-US entities certain documentation, due diligence, withholding and reporting requirements with respect to accounts and certain payments. Investors should consult their independent tax advisors about investment tax implications.

The contents of this document are confidential and may not be reproduced or further distributed to any person or entity, whether in whole or in part, for any purpose without prior written permission.

Investment products:

ARE NOT A BANK DEPOSIT OR OBLIGATION OF THE BANK OR ANY OF ITS AFFILIATES	**ARE NOT FDIC INSURED**	**ARE NOT INSURED BY ANY FEDERAL GOVERNMENT AGENCY**	**ARE NOT GUARANTEED BY THE BANK OR ANY OF ITS AFFILIATES**	**MAY LOSE VALUE**

All decisions regarding the tax implications of your investment(s) should be made in connection with your independent tax advisor.

Appendix 1
Example: Global Perspective in Action

Taking Advantage of Investment Opportunities with a Global Perspective

The potential benefits of the global high yield opportunity set are clear. But how can the investor realize these benefits? To add value above and beyond the already attractive risk-adjusted returns that the global HY market can offer, we believe investors should capitalize on relative value between regions, sectors, issuers and issues. This is done most efficiently with a combination of exhaustive local credit research and portfolio management as well as comprehensive global macro-economic expertise.

Global spreads

From a global perspective, spread differentials between different regions represent potential opportunities for investors. Many global companies now take advantage of both US and Euro high yield markets, issuing in both USD and EUR in order to take advantage of a larger investor base. There are general relationships in terms of spread, for example, that typically hold between USD and EUR issues. However, we can find instances where this relationship breaks down, providing an opportunity for a global investor.

> **Example:** A recent high yield issuer priced a 7-year EUR bond at 6.875% and a 7-year USD bond at 7.375% or 50 basis points behind the EUR tranche. This pricing looked appropriate based on the duration adjusted spread difference between the two markets of around 50bps at that time.
>
> At the same time, we found another company with a large capital structure whose USD 8-year bonds were trading 90 basis points behind its equivalent EUR 8-year bonds. This spread differential presented a relative value opportunity between regions that a global manager could capitalize on.

We can often find this kind of mispricing opportunity when an issuer is less covered from a credit research perspective outside of its native market.

Appendix 2
Benchmark Descriptions

The **BofA Merrill Lynch US 3-Month Treasury Bill Index** is comprised of a single issue purchased at the beginning of the month and held for a full month.

The **Barclays Global Aggregate Index** provides a broad-based measure of the global investment-grade fixed income markets.

The **BofA Merrill Lynch Global Corporate Index** tracks the performance of investment grade corporate debt publicly issued in the major domestic and eurobond markets.

The **BofA Merrill Lynch US Corporate Index** tracks the performance of US dollar denominated investment grade corporate debt publicly issued in the US domestic market.

EM Corp HY – The BofA Merrill Lynch High Yield US Emerging Markets Corporate Plus Index tracks the performance of US dollar denominated below investment grade emerging markets corporate debt publicly issued in the US domestic or eurobond market.

US HY – The **BofA Merrill Lynch US High Yield Index** tracks the performance of US dollar denominated below investment grade corporate debt publicly issued in the US domestic market.

Global HY – The **BofA Merrill Lynch Global High Yield Index** tracks the performance of USD, CAD, GBP and EUR denominated below investment grade corporate debt publicly issued in the major domestic or eurobond markets.

EU HY – The **BofA Merrill Lynch Euro High Yield Index** tracks the performance of EUR denominated below investment grade corporate debt publicly issued in the euro domestic or eurobond markets**.**

EM HY - BofA Merill Lynch Emerging Markets Index consists of the USD-denominated fixed- and floating-rate U.S. Emerging Markets Index and the fixed rate Pan-European Emerging Markets Index, which is primarily made up of GBP- and EUR-denominated securities.

GBP IG – The **BofA Merrill Lynch Sterling Corporate Index** tracks the performance of GBP denominated investment grade corporate debt publicly issued in the eurobond or UK domestic market.

US IG – The **BofA Merrill Lynch US Corporate Index** tracks the performance of US dollar denominated investment grade corporate debt publicly issued in the US domestic market.

EU IG – The **BofA Merrill Lynch Euro Corporate Index** tracks the performance of EUR denominated investment grade corporate debt publicly issued in the eurobond or Euro member domestic markets.

IG ext. EMD - BofA Merrill Lynch High Yield US Investment Grade Emerging Markets External Sovereign Index tracks the performance of US dollar denominated investment grade emerging markets sovereign debt publicly issued in the US and eurobond markets.

Standard and Poor's 500 Index is a capitalization-weighted index of 500 stocks.

The **MSCI ACWI Index** is a free-float weighted equity index and includes both emerging and developed world markets.